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18 October 1988

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

SUBJECT: Meeting with Secretary of State Shultz, and
Messrs. Kampelman, Armacost, and Kamman.
19 October 1988 - 1600 hours - State Dept.

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- Finally, you may wish to share your views on the official Pakistani report of the crash that killed President Zia. Predictably, the report rejects mechanical failure as the cause of the crash. The Pakistanis clearly find possible sabotage a more politically powerful explanation. We have maintained the position throughout this investigation that the matter is being handled by the Pakistani government. We have no information in addition to that contained in the report.

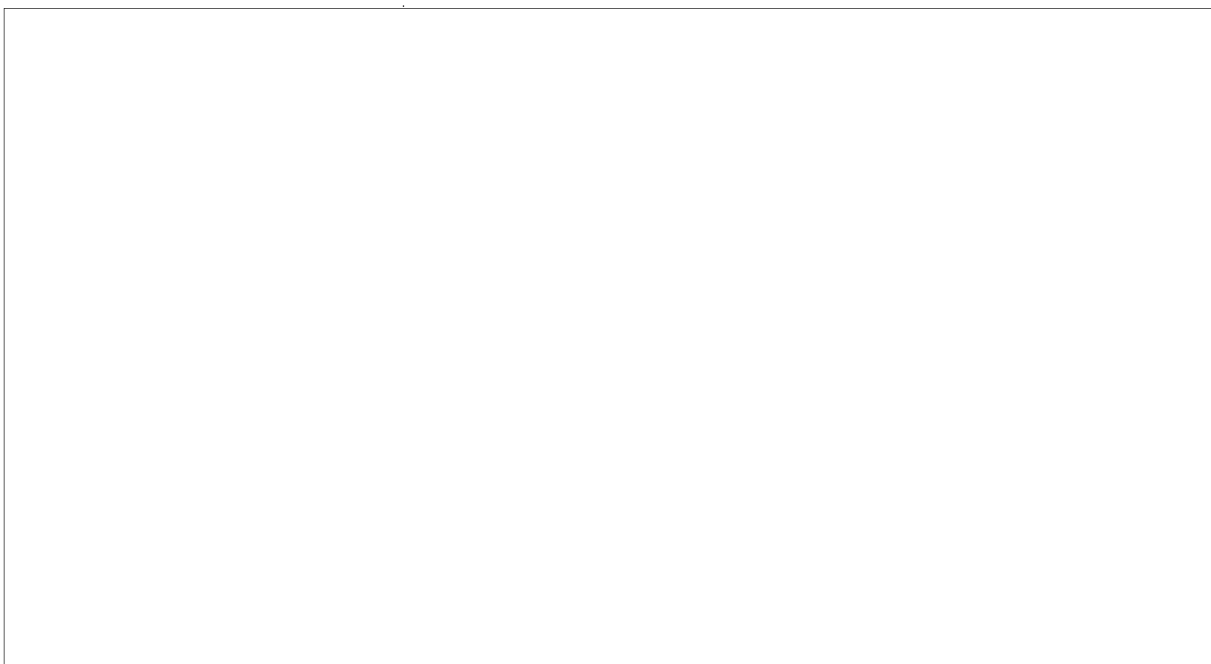
TAB C China. The Secretary of State has asked for your views on two issues currently of importance in China. At TAB C are papers on each of these issues; the likelihood of Sino-Soviet summit in the near future and the impact of slowed economic reform in China. In brief, the DI believes a Sino-Soviet summit to be likely, after the U.S. elections, but as early as next spring. The DI notes the outcome will not presage a return to the close relationship between the two countries of the 1950's. In domestic politics General Secretary Zhao Ziyang and his market-oriented policies suffered a setback on 30 September, but Zhao remains the front runner in the race to succeed Deng Xiaoping.

TAB D Yugoslavia and the Baltic States. The Secretary of State has expressed interest in our assessment of the 'ferment' in Yugoslavia and the Baltic States. In our view, Gorbachev's economic and political experiment in the Baltic represents the leading edge of his overall reform agenda with all the risks and rewards attendant. The conclusion of the talking points at TAB D is that the odds for success are approximately fifty-fifty. In a separate paper addressing the crisis in Yugoslavia, the analysts foresee greater resistance to Serb nationalist leader Milosevic from federal and regional leaders who are interested in maintaining the system of collective, ethnically-balanced decisionmaking in Yugoslavia. While they believe the post-Tito system will remain, the analysts point out enduring stability is unlikely until the country's underlying ethnic and economic problems are dealt with more satisfactorily.

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The Run-Up to a Sino-Soviet Summit

China's leaders clearly are preparing the West and their domestic audience for a summit meeting next year between Deng Xiaoping and Gorbachev. Premier Li Peng expressed the hope that Sino-Soviet relations would be normalized at "an early date" during his 1 October national day address

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Beijing, however, remains vague about the timing, apparently hoping to wrest new concessions from Moscow during the coming exchange of visits by the Foreign Ministers.

- The Chinese are encouraged by Moscow's flexibility on Cambodia, but we believe Foreign Minister Qian will push during his visit to Moscow in late November for a firm commitment from Moscow on an early timetable for a full Vietnamese withdrawal. Qian may also try to encourage Moscow to join with China to initiate a meeting on Cambodia of the five permanent members of the UN Security Council and encourage Moscow to accept an international peacekeeping force in Cambodia.

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- Chinese leaders may have raised the border forces issue--after letting it remain dormant for some time--to assuage the Chinese military's concerns over the pace of Sino-Soviet normalization and to gauge the price Moscow is willing to pay for a summit.

When it occurs, the first Sino-Soviet summit since Khrushchev met with Chairman Mao in 1959 will bring increased trade and technological cooperation, a larger Soviet presence in Beijing, and more contacts at all levels.

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- The two may also be ready to move toward a border agreement, a resumption of party-to-party ties, and a statement of principles on relations roughly similar to the Sino-US Shanghai Communique, but we believe the Chinese are still inclined to move slowly on these issues and may at most be prepared to craft a statement of principles in time for a summit.
- We also expect military contacts to develop as confidence building measures--particularly along the lengthy Sino-Soviet frontier--are agreed upon and implemented, but we do not believe they will extend to major Chinese arms purchases, advanced technology transfer, or genuine military cooperation.

Past disputes, lingering distrust, geopolitical rivalry, and conflicting national ambitions will continue to bound the reconciliation. Recognition that Soviet and Chinese aspirations in Asia will continue to be at odds will prevent a return to the alliance relationship of the 1950s.

- The Chinese believe that the Soviet Union will remain the principal threat to Beijing over the long term. The Chinese are well aware that they are outgunned in every category of equipment along the Sino-Soviet frontier except manpower and that the Pacific Fleet has become the largest in the Soviet navy.
- A commentary in China's military newspaper this week dismissed Gorbachev's offer to withdraw forces from Cam Ranh Bay as a ploy to weaken US forces in Asia and focused attention on the continuing expansion of the Soviet Pacific Fleet.

Beijing reportedly stalled on setting a summit this year in part to prevent Sino-Soviet relations from becoming a US election issue. China may believe that the ideal timing for a summit will be in the Spring shortly after the new US administration takes office to gain leverage with Washington and remind the administration not to take its relations with China for granted.

- Beijing will continue to carefully assess Washington's reaction to each adjustment in Sino-Soviet bilateral ties, however, to avoid alarming the United States and jeopardizing Chinese access to Western technology, trade, and investment. Though Sino-Soviet trade has increased to some \$2.5 billion annually, for example, China's trade with the United States and Japan reached \$24 billion last year.

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Recent Political Developments in China

On September 30, General Secretary Zhao Ziyang and the more market-oriented reformers sustained a setback when the 3rd Plenum of the Communist Party announced a decision to shelve price reform and concentrate for the next two years on dampening inflation and gaining control of the overheated economy. The strategy adopted by the plenum--cutting spending on capital construction, tightening credit, and strengthening administrative controls over the economy--is largely that advocated by Zhao's more cautious rivals, Premier Li Peng and Vice Premier Yao Yilin.

- Li and Yao capitalized on soaring inflation--20-50% in major cities--panic buying, bank runs, and worker protests in August and early September to win support for their approach. Many leaders are fearful that the high-growth, high-inflation strategy Zhao was pushing was contributing to social unrest that could get out of hand if inflation were not checked.
- However, the steps taken thus far--lending limits, higher interest on savings, and a media campaign--are not likely to slow inflation quickly. In fact, the government must print more money soon to pay for the fall grain harvest, which is likely to exacerbate the problems in the short run.
- Zhao's opponents may thus press to toughen controls even more, which would lead to protests from provincial officials and consumers facing scarcities.

Zhao and his supporters will be seeking an opportunity to reassert themselves and their more ambitious agenda. They recognize that allowing more traditional policies to dominate for two years, as the decision announced, would make it very difficult to revive momentum for their market-oriented policies.

- We doubt that, over the short term, Zhao's market reforms will be effective in maintaining growth without fueling inflation. Thus neither side will have much success in handling China's economic problems and defusing popular criticism.
- Moreover, the balance within the leadership between advocates of cautious and radical policies is so fine that neither group is in control long enough for its policies to have lasting effects. Zigs and zags in policy are likely to continue, and the risk of policy paralysis is high.

Over time, this struggle could affect the succession to Deng Xiaoping. In our view, Zhao's influence has been weakened, and his

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efforts to establish himself firmly as successor to Deng Xiaoping's position as de facto leader have been hurt. He has apparently ceded important areas of economic policy--for example, the inflation-fighting campaign--to Li Peng. However, Zhao remains the front-runner in the succession race, and we do not believe he is now in danger of losing the general secretaryship.

- There is some disagreement in the community over how seriously Zhao's prestige has been damaged, and State analysts tend to be more optimistic than we. Some State analysts believe Zhao may have let Li have the anti-inflation portfolio because it is a no-win job.
- Deng Xiaoping, 84, still backs Zhao, but seems to be increasingly in the background. As the succession draws closer, many leaders are taking a wait-and-see attitude. Deng himself may also realize that, to succeed him, Zhao has to be seen as capable of fighting his own battles.

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Talking Points for DCI on USSR: Unrest in the Baltic

President Gorbachev's economic and political experiment in the Baltic represents the leading edge of his overall reform agenda, with all its risks and rewards. His apparent tolerance and even encouragement of some aspects of Baltic autonomy is based on the hope that the region can provide a model for revitalizing the stagnant Soviet economy.

He sees the Baltic as a critical testbed for his reform efforts.

- o He uses examples from the Baltic area to cite success for some aspects of his agricultural reforms, particularly family leasing.

[REDACTED] Gorbachev hopes to make the Baltic into a non-confrontational model for dealing with nationality problems in contrast to his tough response to the conflict between Azerbaijanis and Armenians.

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- o [REDACTED] also indicated that Gorbachev is considering more liberal joint venture arrangements in late November, possibly paving the way for the region's ultimate entry into international financial organizations.

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- o [REDACTED] planning a sweeping purge of the local party organizations replacing hardliners who constituted half of the local personnel and are blocking his progress.

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However, he also realizes that Baltic nationalism could undermine his entire program.

- o The driving force behind the recent surge of national self-consciousness and political activism in the Baltic is a resentment of Moscow's policies which Baltic nationalists view as colonial.

- o [REDACTED] Gorbachev was very concerned with the Baltic and the Ukraine where ethnic violence could derail his reforms. [REDACTED] has compared the situation to ethnic problems in Yugoslavia, and warned that the likely economic success of the Baltic will fuel resentment among the Russians and people in less developed regions.

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In particular, Gorbachev experiment in allowing more autonomy to the Baltic carries four major risks:

- the loss of party control
- the risk of a violent Russian backlash
- encouragement for vetting similar nationalist demands

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--the risk that local nationalists will get carried away and demand independence.

Gorbachev is counting on political maturity and moderation among the Balts, who have less of a tradition of violent nationalism than some groups and have a stake in working within the system, but it remains a major gamble.

- o Instead of coopting the Popular Fronts, which have become de facto opposition parties, the party is coming increasingly under their control.
- o Dissidents in Lithuania claim that the front there has "practically usurped control" from the party and state and the new president of Latvia admitted that he could not rule out the possibility that non-communist delegates would be a majority in the Latvian congress in the near future.

Signs are mounting of a violent Russian backlash in the Baltic.

- o The appearance of appeals to violence among Russian-speakers in Estonia and Latvia, who see themselves as the main losers as the region becomes more independent, and reports that some party hardliners are encouraging ethnic tensions to derail the process are danger signs for Gorbachev's program.
- o A major inter-ethnic clash, like that occurring in the Caucasus, could torpedo any progress, as Gorbachev reportedly realizes.

Moreover, the Baltic popular nationalist movement is increasingly becoming an inspiration to non-Russian minorities in other regions of the Soviet Union.

- o Other nationalists have parroted the Baltic demands on language, the environment, economic autonomy, and restrictions on military service to their home republic.
- o Renewed national fervor is reported in the Western Ukraine, Georgia, and Moldavia--in addition to Armenia and Azerbaijan--and there is evidence that these nationalist groups are increasingly coordinating their activity.

The recent leadership changes in the Politburo have relieved some of the pressure for a crackdown on national unrest and tilted Moscow's leadership in the direction of tolerance.

- o With less pressure from the more orthodox members of the Politburo, Gorbachev has bought some time to work out his economic and political experiment in the Baltic republics

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where support for his most radical proposals is the strongest and where he believes his programs have the greatest chance for success.

o Despite this, considerable reservation remains in the Politburo and Central Committee to which Gorbachev is answerable. His challenge will be to maintain control, forestall unacceptable demands for independence, and prevent a violent backlash from the local Russian minority. His prospects for success are probably no better than fifty-fifty, and a major policy failure here could severely damage the credibility of his whole reform program.

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Talking Points for DCIYugoslavia: No Quick Solutions to the Crisis

Federal and regional officials are likely to blunt Serbian party chief Slobodan Milosevic's (pronounced Mee-LOH-sheh-veech) bid to overturn the post-Tito system of collective, ethnically balanced decisionmaking in favor of strong Serbian-led rule. In the coming weeks they are likely to put up greater resistance and have a good chance to curtail the mass Serb demonstrations and other pressure tactics that Milosevic has used to create the most serious threat to stability in decades. Even so, enduring stability is unlikely until the country's underlying ethnic and economic problems are dealt with more satisfactorily.

National and regional leaders this week began to stand up to Milosevic's strongarm tactics and his bid to reimpose Serbian hegemony with himself as the country's dominant powerbroker.

- National Party Chief Stipe Suvar (SHOO-vahr) in the keynote address to a Central Committee Plenum Monday indirectly criticized Serbia for promoting nationalism and tolerating attacks on former President Tito.
- Other officials at the plenum also denounced ethnic Serb demonstrations, a key source of Milosevic's recently increased prominence.
- Six of Yugoslavia's eight regions in recent days have increasingly criticized Serbian nationalism. Some even have implied that Milosevic is seeking dictatorial powers.
- Senior officials in the mainly Serb military leadership, who have been silent for most of the current crisis, have begun implicitly warning against Serbian nationalism and Milosevic's tactics. They have indicated the Army will accept whatever orders it receives from the national leadership to ensure the country's unity.

A failure by Milosevic at this week's Plenum to replace his many foes with more compliant officials would set back his larger goals but is unlikely to wholly shunt aside his pro-Serbian agenda.

- While up to one-third of the national Party leadership may be replaced at the plenum, the new national leadership may not be beholden to or supportive of Milosevic. Press reports indicate that

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the replacements will continue to represent their regions and reflect traditional parochial ethnic interests.

- Nevertheless, Milosevic could play down any losses and refocus efforts within Serbia by consolidating his recently gained greater power over the autonomous province of Vojvodina and stepping up efforts to remove the leadership in Kosovo, Serbia's other autonomous province. This would give Serbia a somewhat stronger voice in national policy.
- Milosevic could also continue to defy the national Party leadership by using his mass popular following to push for greater Serbian influence in the country. He may exploit a planned march in Belgrade next weekend by hundreds of thousands of Serb demonstrators to again air his demands or even sharpen them.

Even if Belgrade can rein in Milosevic, the prospects of instability will remain high as long as the weak national leadership fails to take tough steps to dampen ethnic nationalism--especially among his Serb supporters--and improve economic performance.

- The new leaders chosen at Tuesday's plenum will probably be no more effective than their predecessors in solving key problems.
- Dissatisfaction with Premier Branko Mikulic's (MEE-koo-leech) handling of the economy is so great that he and his cabinet could face a vote of confidence within six months. No new government--including one led by Milosevic--is likely to implement the kind of economic reforms needed to promote recovery and stem inflation now running at more than 200 percent.

The current developments in Yugoslavia threaten US interests for several reasons:

- While the current political turmoil is indicative of the partial democracy that has evolved in Yugoslavia, Milosevic's goals and the escalation of ethnic antagonisms are a danger to previously developing democratic processes and pluralistic institutions.
- Military intervention would likely be accompanied by significant human rights abuses.
- Yugoslav economic objectives and the likelihood of Belgrade's meeting commitments to the IMF are further threatened, and new demands for Western economic aid are likely to be more vociferous.

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